SENATE TAXATION
EXHIBIT NO. 11
DATE 2.16.11
BILL NO. SB273

Montana Department of Revenue

Dan Bucks
Director

Brian Schweitzer
Governor

To: The Honorable Bruce Tutvedt, Chairman Senate Tax Committee

From: Dan Bucks, Director of Revenue Dan Bucks

Cc: Members of the Senate Taxation Committee

Re: Supplemental and Original Testimony on SB 273—Five Year Corporate Tax Statute of Limitations

Please find attached supplemental testimony on SB 273 that would adopt a five-year statute of limitations for corporation taxes equal to what applies to individual taxes. Also attached is a written copy of my original testimony to the Senate Taxation Committee.

I am providing copies for distribution to committee members.

Thank you.

Supplemental Testimony on SB 273

Adopting a Five Year Corporate Tax Statute of Limitations

Dan Bucks, Director of Revenue

February 14, 2011

SB 273 Does Not Reopen Closed Tax Returns

Contrary to some statements made during the hearing on SB 273, the bill does not reopen closed tax years. Further, corporation records will be available for audit and should not have been destroyed under the terms of existing law.

Understood correctly, SB 273 will keep open for two more years tax returns that are currently open under Montana law. Specifically, those are tax returns for tax year 2007 and later. The due date for tax year 2007 returns was May 15, 2007 at the earliest, and those returns are open under current law through May 15, 2011. Further, most large corporations file returns on the extension date of November 15, so in many cases 2007 return are actually open through November 15, 2011. Hence, the bill will not reopen tax returns that are closed.

There should be no problem of corporate records having been already destroyed for tax year 2007 because the returns for those years are still open under state law—and are subject to federal audit through 2014 under the IRS option to extend the statute of limitations to 6 years.

Understanding the Positive Economic Benefits of SB 273 and Equitable Tax Compliance

One opponent to SB 273 disagreed with the idea that SB 273 would have positive effect on jobs in Montana. That statement reflects a lack of understanding of the key role that a "level playing field" maintained by equitable tax compliance plays in supporting a strong economy—including job growth. When a business fails to report and pay the right amount of taxes, it is getting an illegal tax subsidy that enables them to secure capital that the free market would not otherwise allocate to them. This improper diversion of capital harms economic efficiency and growth—to the ultimate detriment of jobs. When a taxing authority audits a corporation that has underpaid its taxes, it corrects this misallocation of capital, restores equity to competition in the marketplace and thus improves economic efficiency and growth.

There is also a geographic boost to job growth that occurs when Montana audits out-of-state companies and corrects their underreporting of income. In such instances, the state audit returns money to Montana to circulate in our economy again—thus, creating jobs. This job-creating geographic benefit is especially important in the context of SB 273 which will enable the state to more effectively audit out-of-state corporations without additional staff.

In 1972, the Montana Constitutional Convention addressed the importance of equity in taxation to supporting an open and growing economy and increasing jobs. Constitutional Convention Delegate David Drum—a successful businessman, a founder of the KOA campgrounds and also a former state legislator —spoke to the tax equalization recommendations of the Revenue and Finance Committee as follows:

Now what effect will true equality have of taxation? . . . Our group (referring to the Revenue and Finance Committee) feels that if Montana is to go ahead, we are going to have to have equalization in the eyes of those who would like to either stay in Montana and invest money or those who would like to come to Montana and invest money, creating more jobs for our young people.

Delegate Drum and his colleagues believed that to encourage long term investment and growth in Montana, an investor would need to be assured that they would not pay more in taxes because someone else—especially a competitor—paid less than their proper share under the law. Efficiency and growth in business and jobs depends on fair and equal competition in the marketplace based on a foundation of everyone paying a fair share of taxes—with no business gaining an unfair advantage over others. In that manner, the Department believes that its activities are vital to supporting sustainable economic growth and higher paying jobs in Montana. SB 273 is both good fiscal policy and good economic policy.

<u>Five Year Statute of Limitation Is More Equitable, Less Costly and Simpler than Federal Practice</u>

During the hearing on SB 273, I was asked to compare the proposed five-year corporate tax statute of limitations with adopting for both corporate and individual taxes the current federal practice that allows the IRS to extend, on a discretionary basis, the statute of limitations to six years if they find underreporting of 25% or more in any single year within the first three years following the filing of a return. Please note that since the hearing we have confirmed that the 25% underreporting threshold applies to a single year within an open three-year period.

Federal policy is unfair to taxpayers as compared to the states current 5-year statute of limitations for individuals. The IRS policy gives an advantage to the taxing authority over the taxpayer because only the IRS can extend the statute. Taxpayers do not have the ability to extend the statute an extra three years to apply for refunds.

Switching the current regular 5-year statute for individual income taxes to the optional 6-year federal policy will reduce state revenues, increase administrative costs and cause greater inconvenience and potential practitioner costs for taxpayers. This switch would decrease the productivity of existing state audits by allowing less time for an orderly analysis and review of a full complement of each year's tax returns. A switch to the federal practice will also introduce a new procedure in state audit administration that will involve identifying each year the returns where underreporting may exceed 25%. That new procedure will take both auditor time and most likely lead to increased letter inquiries to more taxpayers to provide supplemental information prior to the expiration of the original 3-year statutory period. Taxpayers may incur practitioner charges in responding to the increased tax inquiries. The result will be detrimental to both the state and taxpayers alike.

Testimony to Senate Taxation Committee on SB 273

Adopt a Five Year Statute of Limitations for Corporations

Dan Bucks, Director of Revenue

February 10, 2011

Mr. Chairman and Members of the Senate Taxation Committee, my name is Dan Bucks, and I serve as Montana's Director of Revenue. I am here to recommend passage of SB 273 introduced by Sen. Williams at the request of the Governor. This bill is included in the Governor's budget recommendations. I want to thank Sen. Williams for sponsoring this important bill that will improve tax fairness and simplify the tax system—and that will ultimately benefit Montana businesses and help them create higher paying jobs.

In the tax laws, the statute of limitations fixes the normal period for which a taxing authority can audit a taxpayer who has filed a return and, if it is an even-handed statute, for which a taxpayer can amend a return to file for a refund.

For decades, the corporate tax statute of limitations in Montana was five years. At some point in the 1990s, it was shortened to three years—even though the statute of limitations remained at five years for individual income tax purposes including the individuals who own businesses operating as a sole proprietorship, S-corporation, partnership or limited liability company.

So corporations subject to the corporation tax—generally referred to as C-corporations—have an unjustified advantage over individuals and small businesses when it comes to audits. This advantage is doubly unjustified given that multistate and multinational corporations have much more complex returns and books and records to audit than individuals and small businesses do, engage in considerably more aggressive income shifting and tax planning strategies, and based on our audits typically underreport income by 25% or more. Three years is simply not enough time for the state to do a sufficient number of audits of large, out-of-state corporations to ensure that such corporations are fully and properly reporting the income they earn in Montana. Restoring Montana's statute of limitations to five years is only fair to all taxpayers in Montana, and it is simpler for everyone—taxpayers and tax practitioners—to understand if the state has only one statute of limitations for income taxes instead of two.

It is important to note that SB 273 restores the statute of limitations to five years in an even-handed manner. Although the state will have an opportunity to audit a corporation in a five year period, the corporation will have an equal, five year opportunity to request a refund if they find an error they made in their original tax return.

How does SB 273 compare with the federal government and the majority of states? The answer is that in the context of corporate taxation, the federal government and over half the states actually have a six-year statute of limitations. (See first attachment.) Their statutes of limitations start at three years, but the IRS and the majority of state revenue agencies can extend the audit period to six years if they find underreporting above a certain threshold which in audits of large corporations is easily achieved. Not only is this de facto six-year statute of limitation practice longer than the five years in SB 273, the federal government and the other states are not even handed in their practice—because only the tax agencies can extend the statute. Taxpayers cannot, at their choice, extend their refund period from three to six years. SB 273, in contrast, is more equitable and even handed because tax authorities and taxpayers have an equal opportunity to use the time period to achieve what they believe is a proper and accurate tax result. The five year statute is also simpler in several audit contexts and is not subject to auditor discretion as to whether a statute should be extended to six years as in the case of the practice of the federal government and the majority of other states.

There is another dimension of fairness and simplicity that is achieved through SB 273 in the context of the owners of pass-through entities that are partnerships or limited liability companies. (See second attachment.) Typically the owners of these entities, and not the entities themselves, are responsible for paying the taxes on income earned by these enterprises. If the owner of a limited liability company or partnership is an individual, that person will be subject to audit and assessments for five years. However, the corporation that owns a share of this business will be subject to audit and assessments for only three. Conversely, if the business owners discover that they overpaid in the fourth or fifth year after filing a return, the individual owner can claim a refund, but the corporate owner cannot. This circumstance is not only obviously unfair; it adds substantial, unnecessary complexity to the tax process for both the Department and the taxpayers. SB 273 will improve tax fairness by ending the disparate treatment of individuals as compared to corporate owners of pass-through entities and it will simplify the tax process in these cases.

What is the impact of SB 273 on small businesses? This bill will have a positive effect on small businesses by protecting them from paying taxes that ought to be paid by large, out-of-state corporations and preventing unfair competition from those same corporations There are over 40,000 businesses in Montana organized as pass-through entities—and increasingly small business owners choose that structure over creating a C-corporation. This bill does not affect pass-through entities in any direct legal sense at all because those businesses and the individuals who own them are already subject to a five-year statute of limitations under the individual income tax. Keep in mind that this is a growing share of small businesses in Montana.

Even though the C-corporation structure is a declining share of Montana small businesses, how does this bill affect them? The answer, in practical tax audit terms, is not at all. Why, because it makes no sense for the State of Montana, given scarce audit resources, to increase audits of small Montana corporations. The bulk of the corporation tax is paid by a relatively few large corporations. For tax year 2007, 500 corporations paid 93% of Montana's corporation tax. These corporations—often Fortune 500 to Fortune 1000 companies—not only represent the lion's share of the Montana corporate tax base, but they also represent the greatest tax reporting problems. Again, our out-of-state corporate audits typically find income underreporting in amounts exceeding 25%. Further, much of this underreporting represents the same issues for which we have audited these corporations before and which they have chosen not to correct.

So this bill is really all about audits of large out-of-state companies—because that is where the largest income reporting problems occur and where the State of Montana achieves the better rate of return on its limited audit resources. There is no reason for Montana to increase what are primarily office and correspondence audits of small Montana corporations, because that is not where the bulk of underreporting occurs or where the best audit rate of return can be achieved.

This bill is also an efficiency measure. With no increase in staff, the state will be able to increase its audit return as reflected in the fiscal note by conducting more effective audits of large out-of-state corporations that are responsible for the major share of Montana corporation taxes.

The net effect of SB 273 on Montana businesses is to bring them the benefits of greater tax fairness—keeping taxes lower for Montana businesses, protecting them from having to pay taxes that should be paid by large, out-of-state corporations and defending them from unfair competition from those same corporations. In this way SB 273 will ultimately help Montana businesses succeed and enable them to create higher paying jobs for Montanans.

I urge your approval of SB 273.

(Attachment I)

Corporate Tax Statute of Limitations

Statute of Limitations	Number of States
4 year statute of limitations with an extension of at least to 6 years if income is understated by 25%	6
3.5 year statute of limitations with an extension to 6.5 years if income is understated by 25%	1
Federal - 3 year statute of limitations with an extension to 6 years if income is understated by 25%	**Federal**
3 year statute of limitations with an extension to 6 years if income is understated by 20% to 25%	18
3 year statute of limitations with an extension to 6 years if income is understated by 50%	1
3 year statute of limitations with an extension to 5 years if income is understated by 25%	1
SB273 Proposal - 5 year statute of limitations same as for Montana individual income tax	-
4 year statute of limitations	2
3 year statute of limitations	18
No Corporate Tax	4

(Attachment II)